Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:CLE:PIT:POSTF-152310-01
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date: October 16, 2001

to: Michael J. Alexander, LMSB Agent

from: Associate Area Counsel (CC:LM:MCT:CLE:PIT)

subject: [redacted] - **Holding Period of Contributed** [redacted] **Stock**

This is in response to your request for advice received in this office on September 19, 2001. This memorandum should not be cited as precedent. This memorandum is subject to 10-day post review by our National Office and, therefore, is subject to modification.

ISSUE

What was [redacted]'s holding period for the [redacted] shares received by [redacted] in exchange for [redacted]'s shares in [redacted]?

ANSWER

There is no transfer or exchange basis in the [redacted] shares in the hands of [redacted] because the shares were received in a taxable exchange under the Internal Revenue Code. Accordingly, the provisions under I.R.C. § 1223(1) are inapplicable. [redacted]'s holding period in the [redacted] stock began on [redacted], when the transactions discussed below closed.

FACTS

There were certain assets ("Acquired Assets") used by members of the [redacted] in the conduct of the [redacted] ([redacted]). [redacted] decided that it wanted to sell the assets of this "[redacted] business" and an investor group wanted to purchase the assets. To that end, the investor group and the [redacted], as well as a related partnership involved in the [redacted] business, entered into a "Recapitalization Agreement" dated [redacted]

[redacted]. The [redacted] business was sold for $[redacted] in [redacted].

LEGEND of PARTIES:

Parent - [redacted]

[redacted] - [redacted]
Created in [redacted]
wholly-owned subsidiary of [redacted]

Holdings - [redacted]
[redacted] corporation created in [redacted].
wholly-owed subsidiary of [redacted]
Initially capitalized with approximately $[redacted] and had [redacted] shares of stock issued and outstanding in hands of Parent
(f/k/a [redacted])

Operating - [redacted]
[redacted] corporation created in [redacted]
wholly-owned subsidiary of [redacted]
Initially capitalized with approximately $[redacted] and had [redacted] shares of stock issued and outstanding in hands of Parent
(f/k/a [redacted])

Partnership - [redacted]
Ohio general partnership

[redacted] - [redacted]
wholly-owned subsidiary of [redacted]

[redacted] - [redacted]
wholly-owned subsidiary of [redacted]

[redacted] - [redacted] Delaware corporation, transitory corporation incorporated and capitalized to consummate the purchase of the Acquired Assets by the Investor Group

STEPS/CHRONOLOGY OF THE TRANSACTION

The following summary shows the steps taken to effectuate the sale of the [redacted] business assets to the outside investor group. There was considerable internal restructuring within the [redacted] affiliated group, prior to the merger of [redacted], the transitory acquiring corporation, into Holdings.

The agreement indicated that the steps were to be taken sequentially, and, with the exception of steps 1 through 3, each step was conditioned upon the occurrence of the other transactions. The following steps occurred on [redacted].

Step 1: [redacted] distributed to [redacted] as a dividend, the [redacted] investments and all other Acquired Assets held by [redacted].

Step 2: [redacted] transferred to [redacted] as a capital contribution, [redacted]'s [redacted]% share in Partnership

Step 3: [redacted] acquired from [redacted] and assumed, and [redacted] assigned and transferred to [redacted] as a capital contribution, the Acquired Assets (including, without limitation, the [redacted] investments and all [redacted] Shares) and the Assumed Liabilities, and [redacted] and [redacted] entered into a trademark agreement. [redacted]'s adjusted basis in the Acquired Assets was $[redacted], and that basis was carried over to [redacted] due to the capital contribution.

Step 4: [redacted] transferred to [redacted] as a capital contribution, [redacted]'s [redacted]% interest in Partnership.

Step 5: [redacted] purchased from [redacted], [redacted]'s [redacted]% interest in Partnership (for $[redacted] per closing) with the result that [redacted] owned [redacted]% of the interests in Partnership and the Partnership terminated.

Step 6: Operating purchased from [redacted] and assumed, and [redacted] sold and transferred to Operating, the Acquired Assets (including an assignment of [redacted]'s rights under the trademark agreement between [redacted] and [redacted]) and the Assumed Liabilities for an aggregate consideration of $[redacted].

The $[redacted] was supposed to consist of a $[redacted] demand promissory note payable by Operating to [redacted] and newly issued shares of stock in Operating with an aggregate issuance price of $[redacted]. Operating never issued the new shares. However, the taxpayer argued that Operating should be deemed to have issued the new shares since the board of directors had authorized the issuance of the stock to [redacted] as described above. Operating's failure to physically issue and deliver new stock certificates was

argued to be a ministerial step which should be viewed as an empty and unnecessary gesture. [redacted] (b)(2)High, (b)(7)e

[redacted]

This transaction was reported as an inter-company sale (resulting in momentary deferred gain) of the Acquired Assets by [redacted] to Operating.

Step 7: [redacted] transferred to [redacted], as a capital contribution, all remaining outstanding shares of Operating. [redacted]'s shares in Operating had a basis of $[redacted], with a carryover basis to [redacted] of $[redacted] due to the capital contribution.

Step 8: [redacted] transferred to [redacted], as a capital contribution, all issued and outstanding shares of Holdings. [redacted]'s shares in Holdings had a basis of $[redacted], with a carryover basis to [redacted] of $[redacted] due to the capital contribution.

Step 9: [redacted] transferred all of the stock of Operating to Holdings. The consideration was supposed to be newly issued stock of Holdings with an aggregate issuance price of $[redacted] (the value of the Acquired Assets held in Operating, minus the outstanding note from Operating to [redacted]. However, as in Step # 6, no additional stock in Holdings was actually issued, but there is a "deemed" issuance of additional Holdings stock valued at $[redacted]. The only reason the additional shares were not issued was because said issuance was viewed as an empty and meaningless

[1] (b)(2)High, (b)(7)e [redacted].

gesture. Due to the binding commitment to sell to the Investor Group, this was treated by the taxpayer as a taxable sale.

Step 10: [redacted], as the seller, and Holding, as the purchaser, made an election under section 338(h)(10) for Holding's purchase of the stock of Operating detailed in Step 9. Therefore, the sale was treated as a sale by Operating of its assets to "New Operating" and a section 332 liquidation of Operating into [redacted]. This election has been accepted as valid.

Step 11: [redacted] made capital contributions to [redacted] in an aggregate cash amount of not less than $[redacted], with [redacted] issuing to the [redacted] shares of stock with respect thereof.

Step 12: [redacted] merged with and into Holdings, with Holdings surviving the merger, under Section 251 of the General Corporation Law of the State of Delaware.[2] Subsequent to the merger, Holdings changed its name to [redacted].

Step 13: Pursuant to and immediately following the merger, [redacted] received [redacted]% of [redacted]'s outstanding common stock, while [redacted] received cash of $[redacted], [redacted]'s preferred stock valued at $[redacted], and [redacted]% of [redacted]'s common stock[3],

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[2] The taxpayer, in a [redacted] letter from counsel [redacted], has stated that [redacted] did not purchase the stock of [redacted]. Rather, it was stated that [redacted] was merged into [redacted] in a transaction treated for Federal tax purposes as a sale of the Holdings stock to [redacted], with [redacted] and the merger being disregarded", citing for support Rev. Rul. 90-95, 1990-2 C.B. 67; Rev. Rul 78-250, 1978-1 C.B. 83; Rev. Rul. 73-427, 1973-2 C.B. 301. In an [redacted] memorandum of law by [redacted], it is stated that [redacted] has always considered the disposition of the Acquired Assets as a taxable asset sale. Further, it was admitted that the disposition of the Holding's stock could not be a tax-free reorganization because there was no continuity-of-interest.

[3] On page 6 of the [redacted], memorandum of law by [redacted], it was stated that [redacted] "retained [redacted]% of Holding's issued and outstanding common stock." On page 8 of the same memorandum, it was stated that [redacted] in the reverse cash merger received Class A voting common stock, Class L-1 common stock, and Voting Convertible Preferred Stock having

valued at $[redacted] ([redacted]% of $[redacted]). It is our understanding that, pursuant to the plan of merger, all of the issued and outstanding shares of Holdings held by [redacted] were exchanged and converted into [redacted] shares of Class A common; [redacted] shares of Class L-1 common; [redacted] shares of Series A Preferred; [redacted] shares of Series B Preferred; and $[redacted] in cash. The Restated Certificate of Incorporation of [redacted] details the distribution priorities, voting rights, and stock split/dividend restrictions related to the various classes of preferred and common stock.

This transaction was reported as a fully taxable sale of the stock of Holdings by [redacted] to Investors, which triggered recognition of the gain on the inter-company sale described in Step 6. The taxpayer maintains that no additional gain was reported on this stock sale because [redacted]'s basis in the stock of Holdings was equal to fair market value received in the exchange.[4]

Step 14: Operating obtained debt financing in the aggregate amount of not less than $[redacted] in the form of senior secured credit facilities and senior subordinated notes.

Step 15: Operating paid $[redacted] cash to [redacted] as payment in full of the Demand Note.

Step 16: Operating and [redacted] entered into a trademark agreement as replacement of the TM agreement referenced in steps 3 and 6 above, which was cancelled.

Following the purchase of the Holdings stock by the Investor Group, and the merger of the transitory acquisitive corporation into Holdings, with Holdings surviving and changing its name to

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an aggregate value of $[redacted] and voting power of [redacted]%.

[4] The consideration received, as stated above, was taken from the [redacted] letter of [redacted]. The consideration was $[redacted]. It is our understanding that [redacted]'s basis in the Holdings stock, due either to the deemed issuance of additional stock or to the attribution of additional basis to the shares already held, should be $[redacted]. **Please review this information for the possibility of a $[redacted] gain on the stock sale.**

[redacted] contributed the following [redacted] stock to [redacted] shares of Class A common stock and [redacted] shares of Class L-1 common stock.

[redacted] maintains that its holding period in the contributed [redacted] stock was the same as its holding period in the Holdings stock since the Restated Certificate of Incorporation shows that [redacted] is the same company (i.e., Holdings), just with a new name and a recapitalization with [redacted] shares of common stock authorized and [redacted] shares of preferred stock authorized. It is then argued that [redacted]'s holding period would have commenced on the date of Holdings' incorporation, [redacted], since [redacted] would have had the same holding period as [redacted] by virtue of the carry-over basis resulting from the section 351 contribution of the Holdings stock by [redacted] to [redacted]. I.R.C. §§ 351, 362(a)(1), and 1223(2). This argument, however, does not address the additional Holdings shares that were "deemed" to be issued and delivered to [redacted] in exchange for all of the stock of Operating (see Step 9). Moreover, this argument ignores the taxable sale to the investor group.

DISCUSSION

I.R.C. § 1223(1), in relevant part, provides:

> In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and ... the property exchanged at the time of such exchange was a capital asset... (emphasis added)

In essence, under this provision the property received in an exchange will have the same holding period as the property exchanged if the income tax provisions of the Internal Revenue Code (Chapter 1) provides for an exchange, or substitute, basis in the property received by the taxpayer (e.g., I.R.C. § 358(a), which gives a shareholder who has exchanged his shares in a target corporation for shares in the acquiring corporation, in a tax-free reorganization under section 368, the same basis in the new shares that he had in the old shares). Basically, a taxpayer will have an exchange or substitute basis only in exchanges which are tax-free under some nonrecognition provision of the Code. This is because the exchange or substitute basis, and the

substitute holding period, are necessary to preserve the tax attributes of the property exchanged so any later realization event will capture the inherent gain or loss in the property, and the character of said gain or loss.

A taxpayer does not get a substitute basis, or a substitute holding period, in a sale or exchange in which gain or loss is recognized under section 1001 because there is no need to preserve the tax attributes of the property exchanged; there has been a realization event. Further, simply because the basis in the property exchanged is in fact equal to the amount of the consideration or property received in the exchange does not mean that there is a substitute or exchange basis. Rather, the taxpayer has a cost basis in the new property, I.R.C. § 1012, just in the same dollar amount as the basis in the exchanged property. For example, if the property received in a taxable exchange is $[redacted], and the taxpayer's basis in the property is $[redacted], there is in fact no gain or loss to be recognized even though this is a transaction under which gain or loss would be recognized pursuant to I.R.C. § 1001. In this example, there would be no substitute basis and no substitute holding period even though, in fact, no gain or loss was recognized on the exchange. Since there was a recognition event, the taxpayer has a cost basis in the new asset acquired.

In this case, it is asserted that [redacted] realized no additional gain or loss on the sale of its shares in Holding to [redacted], and the merger of [redacted] into Holding, with Holding surviving and changing its name to [redacted], because [redacted]'s basis in the Holdings' shares was equal to the consideration which was received in the exchange. There is no argument that there was a tax-free exchange or reorganization; the taxpayer has consistently admitted that the exchanges in Steps 6, 9 and 12 were taxable sales. Accordingly, [redacted] did not have an exchange or transfer basis in the [redacted] shares it received in the exchange, and would not have an exchange or substitute holding period pursuant to I.R.C. § 1223(1).

It does not matter that the Restated Certificate of Incorporation purportedly shows that [redacted] is the same company (Holdings), just with a new name and a recapitalization with [redacted] shares of common stock authorized and [redacted] shares of preferred stock authorized. The merger of the acquiring corporation into Holdings, with Holdings surviving, was not a tax-free reorganization. There was a recognition event at that time. Accordingly, there is a new holding period for the [redacted] stock received by [redacted] in the exchange.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views. If you have any questions, please call Donna P. Leone at 412-644-3442.

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